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UNCLAS SECTION 01 OF 05 JAKARTA 000868

SIPDIS

SIPDIS
SENSITIVE

DEPT FOR EAP/MTS
DEPT FOR EEB/TPP/ABT/ATP JSPECKS
TREASURY FOR IA-SETH SEARLS AND JWEEKS
SINGAPORE FOR SBAKER
TOKYO FOR MGREWE
COMMERCE FOR 4430/BERLINGUETTE
USDA/FAS/OA YOST, MILLER, JACKSON
USDA/FAS/OCRA CRIKER, HIGGISTON, RADLER
USDA/FAS/OGA CHAUDRY, DWYER
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SUBJECT: RESPONSE: IMPACT OF RISING FOOD/COMMODITY PRICES-INODONESIA

REF: STATE 39410

SENSITIVE BUT UNCLASSIFIED

¶1. (SBU) Summary: The price of most Indonesian staple foods (soybeans, wheat, palm oil, instant noodles, chicken, eggs) has risen rapidly in the past year. In contrast, the cost of rice, the largest component of the Indonesian diet, has declined in Indonesia over the last twelve months. However, the international price is now \$700 per metric ton (MT) higher than the price in Indonesia, creating an incentive to smuggle and hoard rice and putting pressure on local prices. Rice accounts for roughly one-quarter to one-third of poor and near poor household spending. Production of palm oil, rubber, coal, and metals has increased in Indonesia in response to higher prices. Food production has been slower to respond. There have been numerous protests against rising food prices in recent months, but none have been violent.

¶2. (SBU) Summary (Con'd): The rise in food prices has already translated into higher overall inflation in Indonesia. Analysts worry that the need to aggressively fight inflation and slowing world demand will push Indonesia's growth rate below 6.0%, with limited potential for new job creation or poverty alleviation. GOI policies to respond to the food crisis center on increased subsidies and revised trade policies rather than longer term investments in agriculture. Post recommends the GOI take a comprehensive approach to the food price issue that includes cash transfers to alleviate the burden on poor households and policies to revitalize the agriculture sector. Post also recommends that Indonesia and the U.S. coordinate with countries in the region to discourage rice hoarding. End Summary.

Jakarta Cables on Food/Commodity Price Issues

¶3. (U) Post has reported on the political and economic impacts of food prices in the following cables: Jakarta 86, Jakarta 204, Jakarta 216, Jakarta 264, Jakarta 286, Jakarta 671, Jakarta 684, Jakarta 762, Jakarta 780, Jakarta 848, 07 Jakarta 2857, 07 Jakarta 2997, 07 Jakarta 3027, 07 Jakarta 3056, 07 Jakarta 3208.

Demand

14. (SBU) Rice is the most important food source in Indonesia. Rice accounts for roughly one-quarter to one-third of poor and near poor household spending. With roughly 50% of Indonesia's population at or near the poverty line, a rise in the price of rice could substantially reduce the standard of living of over 100 million Indonesians. The World Bank estimates that every 10% rise in the price of rice puts an additional 2 million people below the poverty line (income of \$1.55 a day or less). In contrast to the international price, the cost of rice has declined in Indonesia over the past year, as rice prices were already high relative to international prices in 2007. But the international price is now \$700 per metric ton (MT) higher than the price in Indonesia, creating a significant incentive to smuggle rice out of the country and raising the risk that prices will climb again rapidly this year.

Although analysts expect the rice harvest to be better than last year, the U.S. FAS projects that Indonesia needs to import roughly 1 million tons of rice before at the end of the year to meet consumption needs. Recent studies reveal that 80 percent of the Indonesian population consumes more rice than it produces. In addition, in contrast to other economies, high rice prices have tended to lower real incomes in rural areas in Indonesia, the experts warned.

15. (U) Indonesians also consume large quantities of sugar, soybeans, flour (mainly as a base for instant noodles), palm oil, chicken and eggs. The retail price of flour and soybeans have risen 70% and 44%, respectively, in the past 12 months. The price of cooking oil and instant noodles are up roughly 30% in the past year. The price of sugar has remained fairly constant this year. High prices for

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Indonesian staple foods are likely to persist given that inadequate harvests, growing demand from emerging markets, and increased use of food to produce alternative sources of energy continue to push up international prices. The high price of soybean meal, which farmers use as poultry feed, has also helped drive up the price of chicken and eggs, a key source of protein in Indonesia, by roughly 30% over the past year. The rise in food prices has already translated into higher overall inflation in Indonesia.

16. (U) Analysts expect high rice and other food prices to hit hardest in Java, where income and job growth remain limited. According to executives at Indofoods, sales of wheat base products fell most dramatically in Central Java when the price of wheat began to rise, providing support for the view that purchasing power is lowest in that area. Anecdotal information suggests that Indonesians are responding to higher food prices by buying smaller quantities of food more often and in some cases substituting lower cost alternatives.

17. (SBU) Java is also likely to be the source of most rice smuggling efforts as roads and transportation links there are superior to most other parts of the country, making it easier for illegal traders to move goods. According to discussions with local traders, inter-island trade is up substantially this month, from around 200-250 MT/month to around 500-600 MT month. Traders note that the increase in activity reflects pre-positioning in rice deficit regions in anticipation of local price increases. However, experts also worry this could be an early sign of smuggling. Most of the rice is moving from Java to Sulawesi, where rice is easily smuggled to the Philippines. Incomes outside of Java have increased in response to increased investment in non-food commodities and palm oil, according to local analysts.

Supply

18. (SBU) Production of palm oil, rubber, coal, and metals has increased in Indonesia in response to higher prices. Food production has been slower to respond. The GOI has failed to meaningfully invest in the agriculture sector over the past decade, resulting in deterioration in agriculture productivity. Experts note that Indonesia's fertilizer and seed technology is 30-40 years

old, while irrigation systems continue to age without funds for repair. Indonesia may also lose as much as 30 percent of its harvest in the transition from farm to market due to antiquated harvesting techniques. Land use restrictions also severely limit the size of farms, inhibiting expanded production. The lack of investment in roads and transportation systems in Indonesia limits farmer's access to markets and their ability to respond to higher prices.

¶19. (SBU) Indonesia's fuel and electricity subsidy scheme also restricts the amount of money available to invest in agriculture infrastructure or provide shorter term assistance to the poor. If oil prices remain near \$100 per barrel, Indonesian could spend as much as \$25 billion (roughly 25 percent of the budget) on subsidies this year. Despite these problems, experts expect rice production to be higher this year due to better weather conditions.

Political Impact

¶10. (SBU) There have been numerous protests against rising food prices in recent months, but none have been violent. The level of dissatisfaction with the current government is rapidly rising, but the President remains the front runner in the 2009 Presidential elections at this time. Food price increases in Indonesia to date are concentrated in soybeans, wheat, and palm oil, which comprise a considerably smaller portion of the average Indonesian diet compared with rice. Public dissatisfaction with the government is likely to rise significantly if rice prices begin to increase at a rapid pace.

In a sign that food prices have already had an impact on poor

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household budgets, government stocks of low cost, poor quality rice have declined significantly in recent months. (Note: For additional political analysis please see Jakarta 684. End note.)

Economic Impact

¶11. (SBU) The rise in food prices has already translated into higher overall inflation in Indonesia. The CPI inflation rate jumped to 8.2% (YoY) in March, well outside the central bank's 4-6% target range. Some analysts predict the rate could rise as high as 10% before the end of the year. The GOI's 2008 GDP growth projection of 6.4% is now well above most market forecasts, due to disparate views between the GOI and analysts on domestic demand and investment rates. The government projection is based a continuation of current domestic demand and investment trends, and only a modest decline in net exports. However, market analysts note that soaring food prices and low job growth have reduced consumer confidence, which is now at a two year low. If inflation rates remain high, Bank Indonesia (BI) will also need to raise interest rates, which could significantly slow consumer finance and investment.

¶12. (SBU) On the external side, most analysts expect Indonesian exports to continue to benefit from high commodity prices, but predict Indonesian manufacturing exports will decline this year in response to flagging demand in Japan and the United States. Some GOI advisors have also stated that BI plans to actively maintain or increase the value of the Rupiah in an effort to limit imported inflation, a move that could hurt Indonesian exporters. The cost of imported food and commodity-based finished products are also likely to lift the import bill this year, potentially reducing the trade balance.

¶13. (SBU) The expected slowdown in manufacturing exports will also disproportionately impact jobs, potentially increasing the number people vulnerable to poverty. Every \$1 billion in manufacturing exports creates 242,000 jobs, whereas the same amount of exports of coal, mining, or chemical products create only 12,000, 43,000, and 8,000 jobs, respectively, according to research study by Chatib Basri of University of Indonesia and Gustav Papanek of Boston University. The same study notes there have been no new jobs produced among large and medium firms in Indonesian in the last ten years because of stagnant growth in job-creating export sectors such as manufacturing. Yet 20 million people have joined the workforce since 1997. Most of these people are currently underemployed in the

agriculture sector, living on very low wages and remaining extremely susceptible to poverty, according to Basri and Papanek.

¶14. (SBU) Analysts note that investors are increasingly worried about the ability of the GOI to control the budget in light of rising food and oil prices, underscoring the importance of prudent policy making in the current environment. According to government officials, the President plans to approve a 25% increase in the price of subsidized fuel and kerosene in the next week, in an effort to increase fiscal space to deal with the food crisis. Analysts link the move to growing market concerns about the size of the subsidy bill. (see septel) Markets declined sharply in April in response to worries that the fuel subsidy regime presents an unlimited liability to the government. The Indonesia Stock Exchange index fell 7.1% within the first week of April and the yield on 5-year Indonesian Rupiah government bonds rose to 11.6% from 10.4% over that same period, according to a recent Standard Chartered Report.

¶15. (SBU) Financial markets are also nervous about inflationary pressure in Indonesia. A recent report from HSBC cites Indonesia (along with Vietnam) as the most "behind the curve" in terms of fighting inflation, due to monetary policy loosening in 2007. Reducing the fuel subsidy may increase inflation by as much a 3 percentage points, according to HSBC analysts. Six months ago financial analysts expected the Indonesian economic growth to run close to 7.0% in 2008, on higher investment, domestic consumption, and strong exports. Analysts now worry that the need to

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aggressively fight inflation and slowing world demand will push Indonesia's growth rate below 6.0%, with limited potential for new job creation or poverty alleviation.

Environmental Impact

¶16. (SBU) Rising CPO prices have accelerated the growth of oil palm plantations throughout Indonesia, particularly in Kalimantan, and added to pressures for significant expansion in Papua. This expansion in acreage is often linked to deforestation, as companies or individuals clear forested land to plant oil palm -- a more profitable tactic than planting on existing non-forested land, which entails foregoing a quick return from the harvested timber. At times, land owners fail to plant cleared land with oil palm, leading to deterioration of water catchment areas and increasing runoff. Anecdotal evidence does not suggest any similar large-scale trend with farmers clearing land to plant rice or other commodity food crops, though, in the past, encroachment and coffee planting in national parks in Sumatra was associated with increases in the price of coffee.

Government Policy Response

¶17. (SBU) On February 4, Deputy Chief for Coordination of Agriculture and Marine Resources Bayu Krisnamurthi announced a host of new and ongoing policies designed to stabilize food prices. GOI policies to respond to the food crisis center on increased subsidies and revised trade policies rather than longer term investments in agriculture. The policies include soybean price subsidies for small-scale producers (Rp 1,000 per kg), which has not yet been implemented, rice price subsidies (Rp. 1,600 kg) for 15 kg of rice per household per month, and cooking oil price subsidies (Rp. 2,500 per liter) for poor families. In addition, the GOI will temporarily eliminate import duties on flour and soybeans, and lower import duties on rice to Rp 450 per kg from Rp 550 per kg. The new policies also relax import standards for wheat. The stabilization plan includes provisions to raise the export tax for palm oil and derivative products from 10% to 15% and expand the categories of cooking oil eligible for government-paid value added tax for domestic sales. The GOI also announced policies to accelerate the provision of high quality seeds and promote the development of wheat alternatives.

¶18. (SBU) The GOI has focused more recent policies on rice. The GOI banned rice exports of rice by anyone except the state-owned Bureau of Logistics (BULOG). The GOI also raised the price of rice that

BULOG pays to farmers by 10 percent to 2200 Rupiah per kg. According to officials from the Ministry of Finance, the GOI also plans to announce a cash transfer to poor households in the coming weeks, to offset the impact of rising food prices and fuel prices. The GOI has not announced large scale plans to improve infrastructure or reduce inefficiencies in the agriculture sector. According to press reports, the President recently accepted a proposal by the Indonesian Chamber of Commerce (KADIN) to establish a committee to streamline regulations and reduce bureaucratic requirements for investment in the commodities and agriculture sector. However, it remains unclear if this committee will be an effective means of attracting investment to the sector.

Impact of Post Programs

¶19. (U) USAID established the Agribusiness Market and Support Activity (AMARTA) project to increase productivity, improve quality and expand access to markets for Indonesia's agribusiness stakeholders. As a result of the increased worldwide demand for rice, the AMARTA program has established a pilot project in the village of Agimuga, Papua. This project will provide technical training for good agriculture practices for rice planting and harvesting. It will also provide suitable seeds and technical assistance on pest control in order to increase production of this staple.

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Policy Proposals

¶20. (SBU) Post recommends the GOI take a comprehensive approach to the food price issue by 1) providing cash transfers to the poor to increase purchasing power (rather than imposing price controls); 2) increasing investment in agriculture infrastructure and extension services and reducing restrictions on land and seed use to allow farmers to respond to higher prices; and 3) encouraging investment in labor-intensive manufacturing to increase job growth and reduce the incidence of poverty in Indonesia. Post also recommends the US and Indonesia work with ASEAN and other Asian nations to discourage rice hoarding and correct the current distortions in the world rice market.

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